DOW THEORY LETTERS INC.

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P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year — $60.00 Annually

Registered with the Securities Exchange Commission

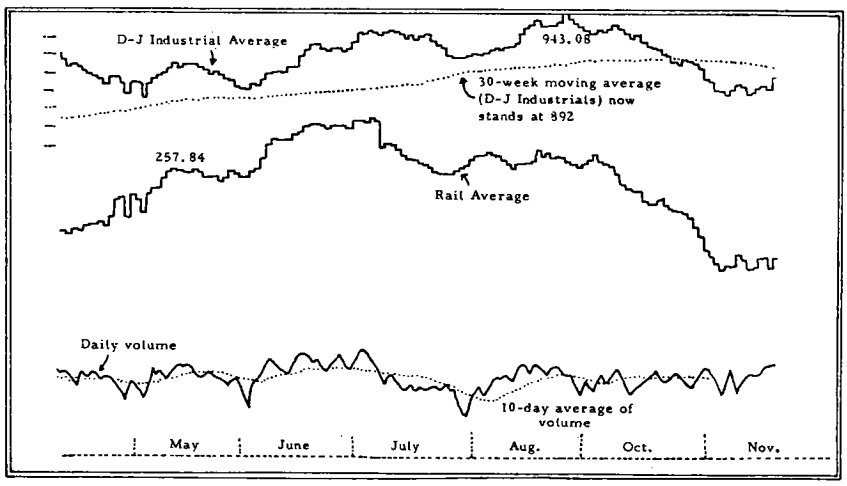
November 24, 1967 Letter 376

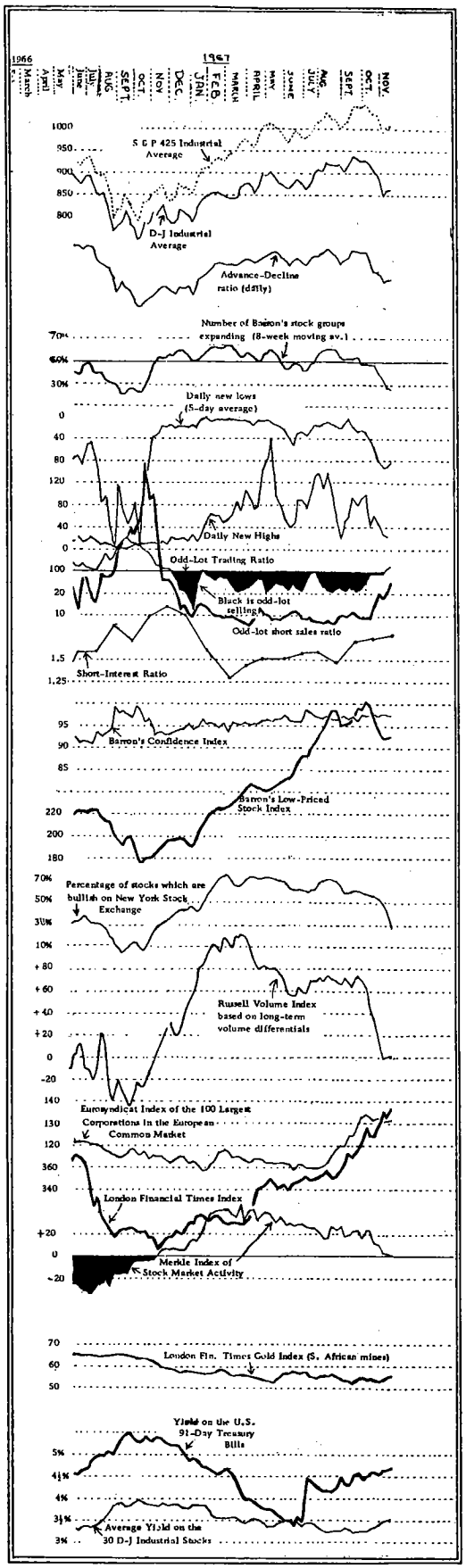
CRACK: After three years of preaching the sanctity of the pound sterling, the British Labor Government finally bowed to reality. On November 18, the pound was devalued by 14.3%, thereby cutting its value from $2.80 to $2.40 in terms of dollars. During the next few days, the financial volcano began to erupt. Israel and Ireland devalued their pounds, Denmark devalued the Krone. This was followed by devaluations in Hong Kong, Bermuda, Fiji, Guyana and Nepal. Spain devalued the peseta by 16.7%. New Zealand and Australia were preparing devaluation statements. In a rapid move, the Federal Reserve upped the U.S. discount rate to 4.5%, in answer to the British rate boost to 8%. Canada boosted its bank rate to 6%, and investors braced for a rash of rate rises throughout the world.

At this point, it seems to this writer that Canada and the U.S. are over optimistic regarding their situations. With devaluation behind it and an 8% bank rate, it would seem that money in Britain would be more attractive to investors than money in the U.S. (with a 4.5% bank rate) or money in Canada (with a 6% bank rate). If this thesis is true, dollars should shortly start moving out of the U.S. and Canada and into Britain — unless there are further U.S. and Canadian rate adjustments, upwards.

The devaluation took most financial writers (who tend to read and believe what everybody else believes) by surprise. Yet anyone who has studied world fiscal and monetary affairs over the past years could hardly have been surprised by the fall of the pound. Certainly, devaluation could not have come as a shock to readers of these Letters (who have long been hedged in gold shares against just such an event).

My friend Harry Schultz, fresh from his daring, personally sponsored International Monetary Seminars, writes in his latest report, "The world is not coming to an end, but the economics of the world are exploding in the manner of an advance stage of chain reaction." I could not agree more. Last week, Irving Weiss of Capital Advisors called me from Palm Springs (he was one of the speakers at the Int. Monetary Seminar). He told me that we are seeing one of the "fastest movements of money in world history." He feels that few will be prepared for the dramatic and violent changes which are coming up. He also opines that Washington is almost powerless to stop the tidal monetary movements which are now being set in motion. "What we are seeing is just the beginning," Weiss said, and I agree.




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurondicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 It was interesting to note that Britain (in the classical manner) denounced and denied devaluation until practically the moment before it became a fact. On the day of devaluation (November 18) President Johnson saw fit to do his duty by saying that the U.S. would "continue to meet its international monetary responsibilities" and "to buy and sell gold at the existing price of $35 per ounce." In the face of the British devaluation, such mouthings (coming from the tongue of one of the world's great inflationists) mean little or nothing.

The situation in Britain is not without its irony. The Labor Government, which promised the people everything good, has now imposed an 8% bank rate (highest in 53 years), massive spending cuts in both public expenditures and military commitments, corporate taxes at 42%, and a severe new consumer credit squeeze. On top of this, the British Empire is being dismantled and the power of Britain has been reduced to the point where the "tight little island" is little more than an inflation-racked remnant of Keynesian dreams.

THE MARKET: From the September 25 recovery high of 943.08, the Dow Industrials dropped in an uncorrected almost straight-line dive to the November 8 low of 849.57. The sell-off consumed a period of six consecutive weeks. Under Dow Theory, every movement is entitled to a corrective move which will serve to retrace one-third to two-thirds of the preceding action. In the last Letter I expressed the opinion that the market was way oversold— that it was overdue for a significant rally.

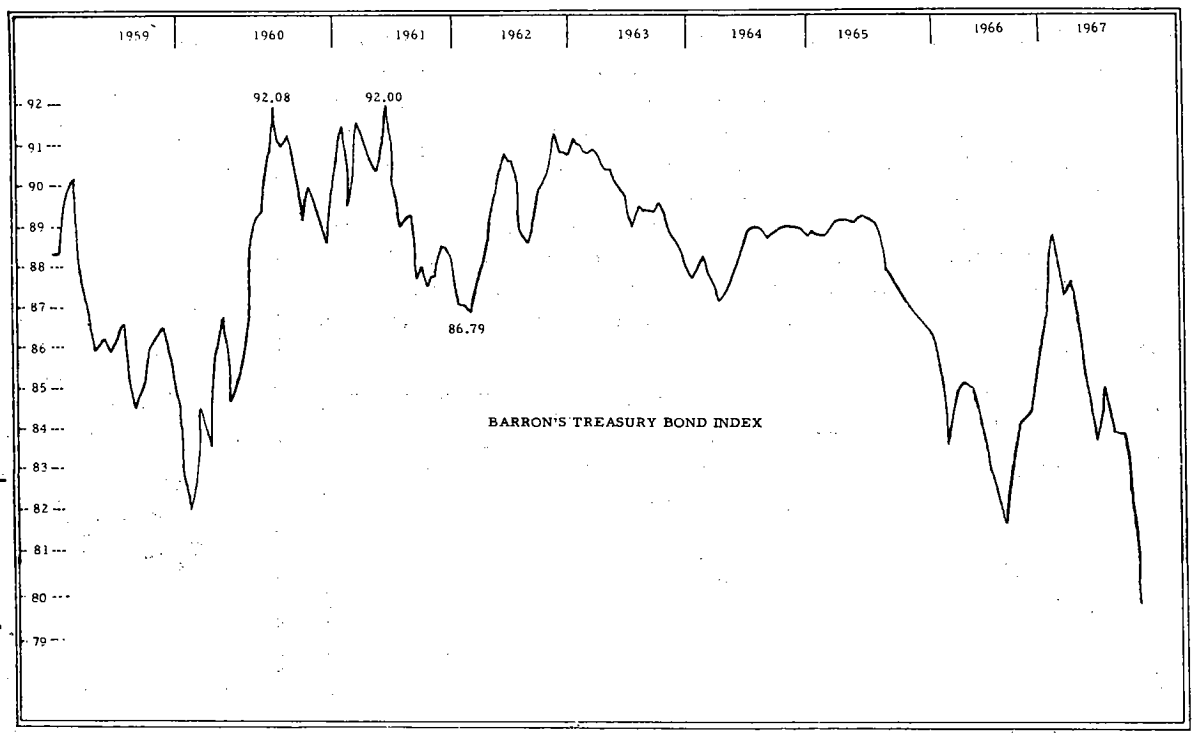
Most rallies start in an area wherein the Averages disagree on the downside. Such a situation occurred on November 14 when the Rails broke to a new low of 227.88. Industrials had struck their low five days earlier, and the November 14 low was not confirmed by a new Industrial low. This set up the technical conditions for a reversal of undetermined proportions.

Over the weekend, the devaluation news hit, and the market opened sharply lower, then recovered. It was a case of a market which was ready (technically) to rally, running headlong into an unforeseen and shocking event. In this writer's opinion, it will take a full week or so before investors are able to properly appraise the results and implications of the British devaluation. It will take at least a month before the flows of money and the potential new round of bank rate boosts come into full view. During that period, anything can and probably will occur on Wall Street.

In the meantime, I caution readers to remember that we are now in the second (and most deceptive) phase of a primary bear market. Shocks, disappointments, violent reversals, and costly surprises are a characteristic of a bear market's second phase. Before this phase is over I believe all subscribers will have reason to understand why I have advocated a protective position of 10% to 15% of assets in gold shares and the rest in 91-day U.S. Treasury bills.

WHERE TO LOOK:

I am presenting my long-term chart of Barron's Treasury Bond Index. Here, in dramatic form, we see the three credit "crises" of the past nine years. This is the story of the bluest of the blue-chip segment of the debt markets of the U.S., the Treasury bonds. These instruments represent all the long-term taxing and reserve power of the U.S. Government.



All very good, but for one rather disconcerting fact. Our Government has been on a drunken spending binge, a binge which now threatens to upset the fiscal structure, not only of the U.S., but the entire Free World. Spending over its head in good years, spending wildly in poor or recession years, spending lavishly in peacetime and spending unbelievable amounts in war years, the U.S. under the guise of fomenting "perpetual prosperity," has literally spent itself into a state of exhaustion.

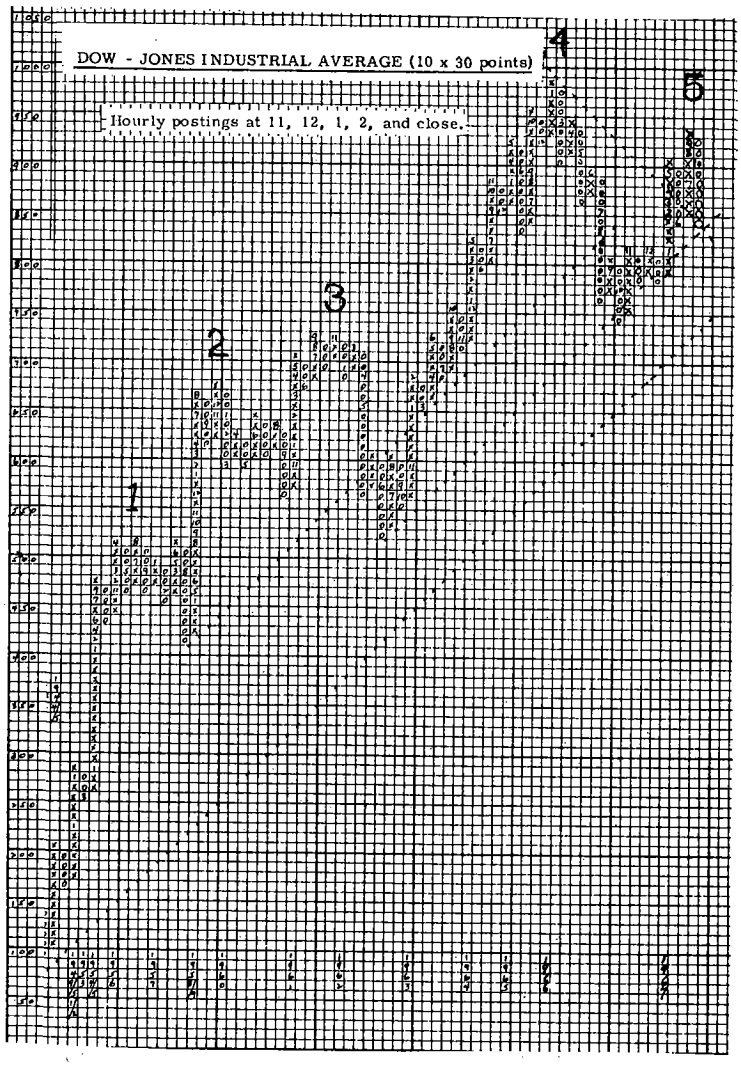
During the 1959-60 crunch Barron's Index dropped from 90 to 82, a severe sell-off by any standards. This was the drop which brought out the first fears about the monetary situation. But the bond market was saved in 1959 by a series of discount rate reductions and massive intervention by the Fed.

The great "double top" in Treasuries came in 1960 and 1961 at 92.08 and 92.00 respectively. From then on, the bear market in bonds (which began in 1946) picked up momentum. The third top occurred in 1963 in the 91 area, following which bonds slid steadily lower. Towards late-1965 and 1966 the slide reached almost panic proportions, and the phrase "money crunch" became a part of Wall Street's vocabulary. During late-1966 and early 1967 the Fed opened the monetary flood gates in an effort to drive interest rates down. It worked— for a short time.

In January, 1967, the Bond Index peaked at 88.56, far below its peaks of 1960, 1961 or 1963. From then on, 1967 has been a "House of Horrors" for the bond markets. A month ago, Barron's Treasury Index smashed to the 81.50 bottom, a bottom which had contained both the 1959 and the 1966 declines. This time, the pressure on the bond market has resulted in chaotic conditions and two weeks ago, for the first time in its history, the Barron's Index penetrated the 80 level. The cave-in since August of 1967 has been vicious and unabated, with many individual Treasury issues falling as much as a point ($10) in a single day. As of this writing, the bulk of the Treasury list is smacking into the 6% yield level, an area which would have seemed unbelievable only a decade ago.

With the debt-value of the U.S. Government collapsing, financial institutions all over the nation are now showing gaping losses in their bond portfolios. The rocketing interest rates are stirring up the fears of financial men and investors throughout the world. Already there is talk of climbing interest rates shutting off the economic recovery of West Germany and with it the economic recovery of all of Europe.

The bond market is approaching the "fireworks" stage, and few even begin to know what to do about it. Worse still, with galloping inflation in this country, with British devaluation, with new whopping increases for labor, the Fed should actually be putting the brakes on the money supply while boosting interest rates. What will occur if the Fed decides in favor of this course can only be imagined. The story so far in this bear market has not been told in the stock market. It has been told in the biggest market of all, the bond market.



BIG PICTURE: The accompanying chart, I feel, is most instructive. It is a point-and-figure chart from Chartcraft's Monthly Chart Book (Larchmont, N.Y.). This chart, as is the case with all P & F charts, deals only in movement. Time is no factor, although for convenience the various yearly dates are marked on the bottom of the chart. This particular graph is known as a 10 point, 30 point reversal chart. This means that each individual box on the chart is equal to 10 points. All rallies appear as X's. Only reversals which carry 30 points or further in the opposite direction are shown, and when a rally (X's) reverses and turns into a decline of 30 points or more, these declines are shown as O's. Thus no fluctuations or reversals of less than 30 points appear on this chart, and this means that a tremendous amount of concentration is built into the graph.

In studying long-term charts it is valuable to note the area where "something different" occurs. The chart shows that something different has indeed appeared during 1967.

Page 4 Note that there were 5 distinct distribution zones or tops since 1949. The year 1949 represents the year when the great 1949-1966 bull market began. Each zone of distribution (numbered 1 to 5 on the chart) was followed by a downside penetration (actually a P & F "bear signal")and than a further decline to the low for the movement.

Then we see something important. Each final low was followed by a fresh rise to new highs on the Dow. Thus zone 1 (1956-57), zone 2 (1960), zone 3 (1961-62) and zone 4 (1965-66) were each followed by an advance in the Dow Industrials to all-time high grounds. That was the pattern for the past 18 years.

But after 1966 we get a dramatic change in the long-range pattern. Here for the first time we see the Dow failing to rise to new highs (in this case the 1966 high of 995.15). During November the Dow provided a "bear signal" on P & F by declining to the box which represents 850. Note that this box was one box below the previous X, which means that the previous bottom was penetrated. This bearish signal indicates or at least suggests that all of the preceding 1967 action was distribution, and that the distribution is now complete.

Thus we have a situation wherein the Dow, following the 1966 decline, refused to go to a new high and then gave a bearish (or "distribution formation completed") signal. This has not happened since the bull market began on June 13, 1949.

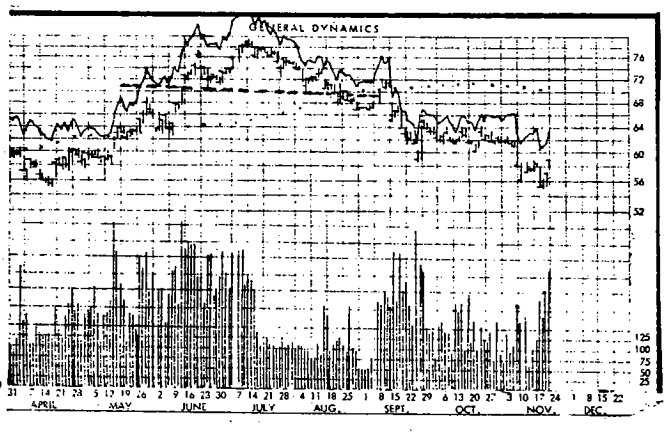
Two levels of interest are now apparent on the chart. The first is the 830 level. If the Dow touches 830 or below, it will penetrate the ascending trendline which has been in existence since 1962. The second point is the 1966 bottom which shows on this chart at 750. In order to penetrate this bottom on a 10-point P & F chart, the Dow would have to decline to 740. Therefore, as far as this graph is concerned, the 830 and 740 levels represent the next two low points of major significance.

COMMENTS: The whole economic picture is assuming a crazy sort of "bigger than life" appearance. The upward cost-push is now becoming almost violent. With whopping new wage settlements hitting the news daily, with the cost of borrowing soaring, with new corporate financing crowding the calendars, American business is beginning to feel the gathering "profits crunch." As economist Eliot Janeway notes in his latest report, ".....it is clear that prices are lagging behind costs, while it is not at all clear that volume will hold long enough to give present and pending price increases a fighting chance to stabilize — especially in product lines vulnerable to import competition."

Meanwhile, the U.S. deficit in the balance-of-payments for the third quarter was a seasonally adjusted $670 million, the worst showing since 1965. This is putting additional pressure on the dollar at a time when its sister currency, the pound, has just fallen.

The surtax is again looming as the political football of the month. Congress has already sunk the surtax once, and many sophisticated authorities considered that the surtax during the election year 1968 had even less chance of passing than in 1967. But now the Administration is mounting a new cry for a surtax, this time based on the dubious theory that a surtax is needed to save the dollar in the face of the pound devaluation. If readers remember, last month's argument was that the surtax was needed to save American consumers from inflation. The real reason that LBJ wants a surtax, of course, is the one he does not tell the voters. He needs a surtax because he needs the money for Vietnam (if the war was called off today LBJ would be asking for a tax cut tomorrow).

STOCKS: As we move into the 1968 election period, it becomes more and more obvious that Mr. Johnson is being pulverized and shredded by the Vietnam issue. The tides of anti-Vietnam opinion are slowly rising, and by 1968 the pressure on our leading elected politician to "do something" is going to be terrific.



One thing he can do is slowly reduce the forces committed to Vietnam. While this is hardly a brilliant idea, it may (for political purposes) help LBJ with his "popularity" fetish. Another thing LBJ may do (or may be forced to do) is to reduce armament expenditures. In fact, as Alden Wells notes in his latest report, the Pentagon is reducing its purchases of armaments, and this past month inventories in the defense industries have actually dropped.

At any rate, reductions or not, something is happening to our "defense giants" as exemplified by General Dynamic, a prime contractor. Here we see the April advance from the 53 area to the July top near 80. But between June and August a perfect little "head-and-shoulders" top formed with its "neckline" or support level at 70.

In September, the support level was broken following a very low-volume right-shoulder rally attempt (in August). Then the deluge. (Chart courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002).